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The Apportionment Formula under the European Proposal for a Common Consolidated Corporate Tax Base

In this article, the author discusses the sharing mechanism suggested in the Common Consolidated Corporate Tax Base proposal, which employs three equally-weighted factors: assets, labour and sales. The author argues that although there is no doubt that the transfer pricing regime should be replaced by a more effective system, designing an adequate method requires taking into consideration the unique characteristics of the European Union and the experience with formulary apportionment in other states.

1. Introduction

In 2001, the European Commission, in its report *Company Taxation in the Internal Market*, argued that the coexistence of 15 different tax systems (now 28) is causing a significant number of tax obstacles to the correct functioning of the internal market.[1] Amongst them, the report alluded to the difficulties encountered in using transfer pricing methods to locate a company's profits, a valuation system that not only hinders cross-border economic activity but also generates inefficiencies in terms of decisions regarding the location of a business and the risk of aggressive tax planning.

The report proposed implementation of a Common Consolidated Corporate Tax Base (CCCTB), which would mean the introduction of a single set of rules to calculate the tax base of corporate groups and distribute the base among EU Member States.[2] In order to make such a distribution, the CCCTB proposal needs to define a sharing mechanism.

Due to the implications of the proposal, both from a political and economic perspective, the potential mechanism for sharing the CCCTB has traditionally been one of the most sensitive issues of the proposal. Because such a mechanism would determine the capacity of each EU Member State to tax the profits of a group, it will be difficult to achieve consensus on this point. The European institutions, aware of this issue, have repeatedly insisted that the sharing mechanism must be fair, equitable, neutral and not susceptible to manipulation.

The first round of debates about the sharing mechanism made a basic distinction between three different alternatives: (i) a macro approach; (ii) a micro approach based on value added; and (iii) an approach based on an apportionment formula. Although the original studies pointed to the conclusion that each alternative had advantages and disadvantages, the European Commission suggested taking into consideration the experiences of the United States and Canada, two countries where apportionment formulas have been successfully used for many years to distribute the profits of a company among states. Since then, all the debates held by the European institutions have focused on the design of an apportionment formula.

2. The Apportionment Formula under the CCCTB Proposal

2.1. Introductory remarks

The sharing mechanism suggested in the CCCTB proposal consists in a three-factor formula, each with the same weight: assets, labour (including wages and number of employees) and sales by destination. This approach uses, as the starting point, the "Massachusetts formula" that has been applied in the United States since 1950, which is also based on the employment of three factors to locate a company's income: assets, wages and sales.[3]

From a comparative perspective, the apportionment formula suggested in the CCCTB proposal is different from the US model in two respects. The first relates to the composition of the labour factor. Unlike the Massachusetts formula, which only includes wages paid by the group, the European proposal also takes into consideration the number of employees. This must be included in the formula at the same weight as wages.[4] In this way, the European Commission wants to ensure that wage differ-

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1. *See* European Commission, Staff Working Paper, Company Taxation in the Internal Market, COM(2001) 582 final (23 Oct. 2001), SEC(2001) 1681, EU Law IBFD.
2. Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, COM(2016) 683 final (25 Oct. 2016), EU Law IBFD [hereinafter CCCTB proposal]. This document was launched at the same time as the Proposal for a Council Directive on a Common Corporate Tax Base, COM(2016) 685 final (25 Oct. 2016), EU Law IBFD [hereinafter CCTB proposal], as part of a dual-stage strategy. The idea is to first implement a common set of rules for calculating corporate tax bases and defer consolidation until a second stage.
3. These factors are regarded as reasonable approximations to the profit that the group obtains in a certain territory, taking into consideration both the demand for the group's goods and services in that state (sales by destination) and the production activity developed therein (assets and labour).
4. As the total weight given to each factor (including the labour factor) is one third, both wages and the number of employees have a weight of 1/6 in the apportionment formula (0.5 x 1/3 = 1/6).

ences amongst EU Member States do not distort the distribution process of corporate tax bases.

The second difference between the US and European models is related to the weight of the factors included in the formula. As opposed to the US model, the European proposal does not recommend that EU Member States adopt a three-factor formula, each with the same weight, but compels them to do so without contemplating any kind of deviation. The grounds for this rule seem to be connected with the lessons that the US experience itself taught. In this sense, there is strong evidence that, when the weight of the factors can be modified unilaterally, states have an incentive to deviate from the initially suggested formula.[5] As a result of this deviation process, double taxation and non-taxation problems arise.

Focusing attention on the European context, the Introduction to the CCCTB proposal points out that:

> the CCCTB features as an effective tool for attributing income to where the value is created, through a formula based on three equally weighted factors (i.e. assets, labour, and sales). Since these factors are attached to where a company earns its profits, they are more resilient to aggressive tax planning practices than the widespread transfer pricing methods for allocating profit.

According to this provision, one of the main objectives of the European proposal seems to be to replace transfer pricing with a new system for assigning corporate profits to the territories where they have been earned. This purpose is closely related to the strategies in the fight against aggressive tax planning being pursued by the European institutions.

As noted in section 1., the analytical study carried out by the European Commission at the end of 1990 brought to light the weaknesses of transfer pricing as a system for allocating corporate profits. Amongst its most important flaws, the Commission established a strong link between the use of transfer pricing methods and the risk of tax evasion. In respect of this point, it is important to highlight that the transfer pricing system was also originally designed for the purpose of making an optimal assignment of a company's profits to the territories where they were effectively earned. In fact, it is technically a perfect method to reach that objective. The problem is that, in recent years, the search by companies for tax savings has unleashed a growing tendency to use this system in a fraudulent way. More specifically, the ease of transfer pricing manipulation has provided cross-border companies and groups with ample room to carry out aggressive tax planning strategies that lessen the capacity of transfer pricing methods to achieve their original objectives.

Initially, it is to be expected that the mere substitution of the transfer pricing system for an apportionment formula will reduce the existing incentives to engage in aggressive tax planning, since the three chosen factors are closely linked to the place where the company develops its economic activity. The implementation of a formula, however, will not put an end to the problem of profit shifting in a definitive way. This is mainly because these factors are potentially subject to manipulation, to a greater or a lesser extent (as currently happens with transfer pricing). This circumstance has led Kiesewetter, Steigenberger & Sitier (2014) to assert that unitary taxation (i.e. the employment of an apportionment formula to allocate corporate tax bases) "creates new opportunities for cross-border tax planning without destroying the old opportunities".[6]

The European institutions are aware that, after the approval of the CCCTB Directive, there will still be room for manipulation, such that the risk of profit shifting will continue to exist. For this reason, the proposal includes a series of anti-abuse rules that will be analysed in the following sections of this article.[7]

2.2. Labour factor (wages and number of employees)

First, article 33.1 of the CCCTB proposal establishes that employees must be included in the labour factor of the company that pays their wages. Immediately after, article 33.2 points out that employees who are formally hired by one entity but provide their work services under the control and responsibility of a different group member (i.e. different from the entity that pays their wages), must be included in the labour factor of the entity for which they are effectively working. This provision will only be applied, however, where two conditions are fulfilled at the same time: the situation referred to must extend for a minimum of three months and the affected employees must represent at least 5% of the payer company's workforce. By including such a rule in the CCCTB proposal, the European institutions want to prevent groups of companies from manipulating the number of employees, and therefore the weight of the labour factor, for the sole purpose of benefitting from tax savings. This strategy could be interesting when members of the group are located in countries with different levels of tax rates, so that the group could have an incentive to formally hire workers in EU Member States with lower tax rates, regardless of the territory in which the entity that is effectively going to control their work is located.

Second, article 33.3 indicates that the labour factor not only includes workers who are directly hired by the group, but also people who carry out tasks substantially similar, or even identical, to those that are assigned to hired employees. With this provision, the CCCTB proposal tries to avoid the use of subcontracting as a mechanism to reduce the weight of the labour factor in countries with higher tax rates. Similar to what happens with the number of employees, the lack of such a rule would leave room for

5. A brief historical overview of the US experience with formulary apportionment can be found in W. Hellerstein & Ch. E. McLure Jr, *The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States*, Intl. Tax and Public Finance 11, pp. 207-208 (2004).

6. D. Kiesewetter, T. Steigenberger & M. Sitier, *Can formula apportionment really prevent multinational enterprises from profit shifting? – the role of asset valuation, intragroup debt, and leases*, Quantitative Tax Research - Arqus Discussion Papers 175, p. 27 (2014).

7. A similar study can be found in K. Boucher, *Multistate Corporate Tax-Saving Strategies*, 12 J. St. Tax'n 4, pp. 23-57 (1984) and K. Boucher & R. Taylor, *State tax studies can benefit corporate taxpayers*, 5 J. St. Tax'n 4, pp. 307-327 (1987).

tax abuse on the part of cross-border groups. Instead of directly carrying out their economic activity, for example, groups could have an incentive to hire the services of a temporary employment company that engages in such an activity without providing anything else. That means that the temporary employment company would carry out the group's activity but by making use of the group's own inventory, intellectual property and know-how. As long as such a strategy is developed in a high-tax location, the use of subcontracting employees would allow the group to obtain tax savings.

As far as the wages factor is concerned, article 33.4 compels the inclusion in the apportionment formula, apart from wages in the strict sense of the word, of all costs associated with wage payments and any other kind of remuneration paid as compensation for the work services provided.[8] This includes costs associated with pension funds and social security. The choice of an extended definition helps to prevent the group from manipulating the labour factor in order to increase (or reduce) its weight in countries with lower (or higher) tax rates. This result could easily be achieved by disguising a wage payment using alternative concepts, such as: payments in kind; gifts; compensation for travelling, accommodation and maintenance expenses; debt payments, etc.

2.3. Assets factor

Article 34 of the CCCTB proposal indicates that the assets factor includes "all fixed tangible assets owned, rented or leased". It can be inferred from this definition that intangible assets, financial assets and inventory are not included in the apportionment formula, since such elements do not fit within the definition of "fixed assets".[9]

The practical effects of this definition are highly relevant, especially when taking into consideration the active fight against aggressive tax planning strategies being carried out by the European institutions. As was supported by the European Commission in its working document, *CCCTB: Possible elements of the sharing mechanism*, inventory can represent an important part of a company's total assets, but it is highly mobile and, therefore, susceptible to manipulation.[10] For example, there could be an incentive for a group of companies to establish a warehouse in a state with low tax rates for the sole purpose of diverting part of its corporate tax base to that territory and, in this way, benefitting from tax savings. Apart from high mobility, financial assets usually have a high value. Such a feature turns them into an effective instrument for carrying out profit-shifting strategies. Intangible assets, in turn, not only share the features of financial assets (high mobility and value), but also raise problems concerning valuation and territorial assignment that invite abuse.

Regarding location issues, article 35.1 of the CCCTB proposal states that a group's assets will be assigned to the EU Member State where its economic owner is located. Only when it is not possible to identify the economic owner will the asset be included in the assets factor of its legal owner. Furthermore, the European proposal also considers the possibility of a sublease, i.e. a situation in which the person or company making use of the asset differs from the person or company that can be regarded as its legal or economic owner. According to the solution that the CCCTB proposal provides, the subleased asset must be allocated to the territory where the economic owner is located, as long as the value of that asset relative to the value of the entity's total assets is more than 5%. If the lease operation is entered into between a company that is part of a fiscal group and a third entity (regardless of the position each one assumes), the leased asset must be included in the assets factor of both parties.[11]

In order to better comprehend these rules, it is necessary to take into consideration the definition of economic owner in article 4 of the CCTB proposal.[12] According to this provision, the person who is to be regarded as the economic owner is:

> the person who receives substantially all the benefits and bears all the risks attached to a fixed asset, regardless of whether that person is the legal owner. A taxpayer who has the right to possess, use and dispose of a fixed asset and bears the risk of its loss or destruction shall in any event be considered the economic owner.

Thus, when a lease operation involves a division between legal and economic ownership, the following question must be answered: when does the formalization of a lease contract imply a transfer of all the risks attached to the asset between the lessor and the lessee?

As stated in article 4 of the International Accounting Standard 17 (IAS 17), related to lease operations, "A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. All other leases are classified as operating leases". The key difference between finance and operating leases lies, therefore, in the transference of all risks and rewards attached to the leased asset between the two parties to the contract. Only in situations in which such risks and rewards are transferred to the lessee can the operation be defined as a finance lease and a distinction can be made between legal ownership of the asset, which will fall on the lessor, and economic ownership, which will fall on the lessee. It is for this reason that article 32.2 of the CCCTB proposal refers to the lack of coincidence between economic and legal ownership as a typical feature of finance lease contracts.

In addition to taking into consideration the existing differences between finance and operating leases, determin-

8. According to art. 33.3, both wages and other related costs will be included in the formula regardless of whether or not the people who receive the money are directly hired by the company.
9. Art. 4 CCCTB proposal defines fixed assets as "tangible assets acquired for value or created by the taxpayer and intangible assets acquired for value that are capable of being valued independently and that are used in the business for producing, maintaining or securing income for more than 12 months, except where their acquisition or construction cost is less than EUR 1,000".
10. Common Consolidated Corporate Tax Base Working Group, *CCCTB: Possible elements of the sharing mechanism*, European Commission Working Document 60 (European Commission 2007).
11. In these instances, the criterion applied to value the asset will be different and art. 35 CCCTB proposal will be reverted to.
12. *Supra* n. 2.

ing the group member to which the leased asset must be assigned requires making a basic distinction between two different situations. Firstly, when the signing parties of the lease contract are part of the same fiscal group, the leased asset must be included in the assets factor of its economic owner. As noted, such a condition will depend on the classification of the lease contract (finance lease or operating lease). In the event the contract is classified as an operating lease, the asset must be included in the apportionment formula of the lessor, who meets the requirements of legal and economic ownership. When the contract can be classified as a finance lease, the asset must be included in the assets factor of the lessee or economic owner. As a second possibility, when the lessor and the lessee are not part of the same fiscal group, the leased asset must be included in the assets factor of both the lessor and the lessee.

Without a doubt, the procedure suggested by the European Commission for allocating income derived from lease operations attempts to prevent companies from carrying out aggressive tax planning strategies. If the CCCTB proposal did not incorporate such a set of rules to confront abuse, each group member would include in the assets factor the average value of its total assets at the fiscal year-end (i.e. the average value of all its legally owned assets). Under these circumstances, cross-border groups might have an incentive to structure their leasing arrangements such that the corporate tax base is shifted to states where the fiscal pressure is lower.

A good example of the kind of tax planning strategy that groups of companies could engage in if the European proposal did not make a distinction between finance and operating leases, would be the following: imagine that one entity (entity A), which is the legal owner of a machine that is used in the development of its economic activity, were part of a consolidated group and established in a high-tax location (such as France). The fiscal group would have an incentive to force the exclusion of the machine from the assets factor of entity A. This result could easily be achieved through a two-stage strategy. First, the group would carry out an intra-group trading transaction (purchase and sale between two group members), so that ownership of the asset would be transferred to entity B, part of the same group but located in a state where tax rates are low (Ireland, for example). Second, the buyer (entity B) and the seller (entity A) would enter into a finance lease contract, according to which entity B (new legal owner) would lend the asset to entity A. As a result of this strategy, the machine would continue to be used in France by entity A (same EU Member State, same entity), but, formally, would be included in the assets factor of entity B, which is located in a different state. Consequently, a greater part of the group's corporate tax base would be assigned to the EU Member State with lower tax rates to the detriment of the EU Member State where the asset is effectively being used.

Concerning the valuation of the assets factor, article 36.5 of the CCCTB proposal addresses the possibility of one entity selling a fixed asset to a different member of the same group and, afterwards, selling the asset to a third person or entity (i.e. to a person or entity not included in the fiscal group). As long as the sale to the third party is carried out in the same tax year as the internal transaction or in the subsequent year, the anti-abuse rule included in article 36.5 of the CCCTB proposal will be applied. According to this rule, the asset must be included in the assets factor of the company that assumed the role of being the seller company within the framework of the internal transaction (i.e. it must be included in the assets factor of the previous owner), unless the fiscal group demonstrates that the internal transaction was justified by commercial reasons.

This legal provision tries to prevent groups of companies from carrying out tax savings strategies, such as the following: entity A, part of a fiscal group and located in a state where tax rates are high, is the legal owner of a machine that it wishes to sell out of the group. If the market price were higher than the fiscal value of the machine, the sale to a third party would mean a profit to the seller company. In a normal situation, that profit would increase the corporate tax base of the group and would be shared among the countries where its economic activity is developed, according to the apportionment formula. If the CCCTB proposal did not establish a special rule, the group would have incentives to force an internal transaction for the sole purpose of transferring ownership of the machine to another company within the same group that is located in an EU Member State where fiscal pressure is lower. Subsequently, the new legal owner of the machine would sell it to the third party for the desired price. As a result of this strategy, the weight of the assets factor in the state with lower tax rates would increase and a greater part of the group's corporate tax base would be assigned to that territory.

2.4. Sales factor

The CCCTB proposal opts for a strict definition of the sales factor in order to guarantee that only those earnings deriving from the ordinary economic activity are included in the apportionment formula. This implies leaving out of the formula other kinds of highly mobile earnings of a different origin and a greater potential for aggressive tax planning, such as dividends and royalties.

Article 37.3 of the proposal also excludes from the apportionment formula earnings from internal or intra-group transactions. While dividends, royalties and earnings of a similar nature are excluded from the formula due to their mobile nature, there are even greater reasons for excluding the results of internal transactions. On the one hand, internal transactions do not increase the group's overall profits. On the other, such transactions would need to be valued using transfer pricing methods if included in the sales factor, with the result that any problems associated with this valuation system would reappear. Given that the main objective of the CCCTB is to substitute a new method of distributing a company's profits among EU Member States for the transfer pricing system, this result would be unacceptable.

Concerning the location of sales, article 38.1 of the CCCTB proposal states that earnings deriving from sales of goods and services must be included in the sales factor of the entity that is located in the Member State where the goods are ultimately transported or, in respect of services, in the Member State where the service is effectively provided. The European Commission seems to opt, in this way, for the *sales by destination* criterion. Complementing this provision, article 38.4 considers the possibility of a fiscal group having no physical presence in the state where the purchaser of the company's goods or services is located (either through an affiliated company or a PE), in which scenario sales must be included in the apportionment formula of all group members in proportion to the other factors. Contrary to initial appearances, the author considers that article 38.4 of the CCCTB proposal is not an anti-abuse rule, but only a technical provision that tries to resolve situations in which sales take place in an EU Member State that lacks the necessary competence to tax the group's profits.

From a comparative perspective, the solution adopted by US law to address these situations consists in the application of the *throwback rule*, according to which sales to those territories where the group does not have sufficient nexus are reallocated to the state where the seller or service provider is located. In these circumstances, therefore, sales profits are not taxed in the state where the purchaser resides (state of destination), but in the state of origin.[13] Contrary to what happens in the United States, the CCCTB proposal does not assign these kinds of sales to the state of origin, but proportionally to all EU Member States where the group has a significant presence for tax purposes. This rule, traditionally known as the *spread throwback rule*, resolves certain doubts that arose under the US model in specific situations (for example, in the event of *drop shipping*).[14]

3. The Proposal's Weaknesses

As the European Commission has pointed out, under an apportionment formula, the group's total tax burden does not depend on its specific volume of profit, but on the presence of the three factors in each EU Member State. This fact turns the formula into an effective method of eliminating (or, at least, significantly reducing) a company's incentive to shift profits to low-tax locations.[15] As some experts have warned, however, the effective implementation of the CCCTB proposal will not completely eliminate the problem of aggressive tax planning in the EU context.

One of the main weaknesses of the CCCTB proposal, however, is that the set of rules suggested by the European Commission for consolidating tax bases and distributing them amongst EU Member States will not, at least initially, be compulsory for all groups that carry out cross-border economic activities in the European Union. As section 3. of the Introduction to the CCCTB proposal lays down, "To meet the objective of enhancing the fairness of the tax system in a proportionate manner, the preferred option for the CCCTB suggest[s] to make it compulsory only for a subset of firms, based on their size". More specifically, the compulsory application of the CCCTB will be limited to those groups with a consolidated turnover above EUR 750 million. Micro-enterprises, small and medium-sized companies, therefore, will be exempt from the Directive, although they will have the possibility of applying it voluntarily.[16]

Such a limited scope of application will make it necessary to continue to apply transfer pricing methods to valuate at least two categories of transactions that are not covered by the Directive: transactions between two members of a fiscal group that is not obliged to apply the CCCTB Directive and has not opted to do it voluntarily and transactions between one member of a fiscal group that applies the CCCTB Directive (whatever the reason be, obligation or election) and a third entity that lacks the necessary conditions to be part of the same group.[17] As far as the author is concerned, this would not only discourage European groups from adhering to the proposal, but might also encourage a variety of reorganizations (such as mergers, splits, purchases and sales of the company's shares, etc.) with the single aim of changing the group's composition and modulating the application of the Directive. Furthermore, the disadvantages of transfer pricing as an allocation method (amongst them, a high risk of tax evasion) will continue to create obstacles and interfere with the correct functioning of the internal market.

Secondly, it should be taken into consideration that all the factors included in the formula are, to a greater or a lesser extent, mobile so the decision to locate them in one state or another can be under a group's control. Although the CCCTB proposal includes a series of anti-abuse rules in order to avoid manipulation of the factors, the experience of other countries using formulary apportionment leads

13. As an alternative, some US states have adopted the "throwout rule". The difference between the throwout and throwback rule is that, when sales are destined for a state where the group has no physical presence, earnings deriving from such sales are not taken into consideration in applying the apportionment formula. Therefore, such earnings are excluded both from the numerator and from the denominator of the formula.
14. "Drop shipping" can be defined as a sales model, increasingly extended and employed by platforms such as Amazon or eBay. Under this kind of retail sale, the retailer does not buy and store products in its facilities, but simply sends shipment details to the wholesaler, who assumes the responsibility for sending the product to the final consumer.
15. *See* Common Consolidated Corporate Tax Base Working Group, *The mechanism for sharing the CCCTB*, European Commission Working Document 47 (European Commission 2006).
16. According to the Introduction to the CCCTB proposal, sec. 3, "Limiting the compulsory application to groups with a consolidated turnover above EUR 750 million serves the purpose of capturing the vast majority (approximately 64%) of turnover generated by groups while limiting the risk of including purely domestic groups. […] At the same time, the proposal offers those companies, for which the application of the CCCTB is not compulsory, the possibility to 'opt-in' to the CCCTB system. This allows for a maximum of flexibility for SMEs and micro-enterprises, offering to benefit from the advantages of a CCCTB without making it compulsory for this set of companies".
17. The application of the CCCTB will be compulsory for those entities that, amongst other requirements, belong "to a consolidated group for financial accounting purposes with a total consolidated group revenue that exceeded EUR 750 000 000 during the financial year preceding the relevant financial year" (art. 2 CCCTB proposal). The concept of "consolidated group" is defined in art. 4, point 10 CCTB proposal as "all entities that are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards or a national financial reporting system".

us to the conclusion that other means of manipulation, not contemplated nor resolved under the European proposal, are possible. The same idea has been defended by Kiesewetter, Steigenberger & Sitier, who argue that implementation of a new method to allocate the profits of companies for tax purposes will only imply that old strategies to alter the magnitude of corporate tax bases will be replaced by new techniques to alter both the location and the weight of the apportionment factors according to the group's interest.[18]

Focusing on the possibilities of manipulation offered by the apportionment formula, the first avenue of aggressive tax planning relates to the suggested rule for calculating the number of employees. Given that article 32.2 of the CCCTB proposal provides that "The number of employees shall be measured at the end of the tax year", groups could have an incentive to fire some workers a few days before the end of the tax year and hire them again at the beginning of the following year. As fired workers would not be included in the apportionment formula under the suggested regime, this strategy would allow the group to reduce the weight of the labour factor in high-tax locations and to benefit from the corresponding tax savings.[19] Carrying out a strategy like this, however, would be more difficult than it seems. This is mainly because the rules regarding dismissal in each EU Member State are different. As such, the level of difficulty of firing workers, both from a legal and an economic perspective, depends on the territory where they are providing their services. Despite this fact, it would be advisable to include a rule for calculating the number of employees in order to avoid any attempt at manipulation.

An appropriate alternative to reach this objective would be to use the average number of employees during the tax year instead of the total number of employees at the end of the tax year. Accordingly, all people that have been providing their services to the group during the tax year, even if made redundant before 31 December, would be counted in determining the weight of the factor. The key element is that each employee should be included in the formula in proportion to the number of days he effectively worked for the group. An employee who is fired on 1 July, for example, would be counted as 0.5 of a worker in applying the apportionment formula.[20]

In relation to the sales factor, the experience of other countries using formulary apportionment has brought to light that a company's capacity to make decisions about the location of sales (i.e. the company's capacity to decide where they sell their goods and services) is limited. In line with this idea, the sales factor has traditionally been regarded as the least capable of being used as a tool for developing aggressive tax planning strategies.[21] The possibility of eliminating physical presence in the state of destination and selling products and services through intermediary agents, however, would lead to the potential of this factor being used for fiscal purposes.

Take, for example, the situation of a fiscal group that wants to sell its products in an EU Member State with a high rate of corporate income tax. If such a group had a PE in the state of destination, sales to that state would be included in the sales factor of the PE.[22] Therefore, the group's corporate tax base would partially be assigned to that territory. A feasible alternative to avoid (or, at least, to reduce) taxation in the state where products are sold would consist in substituting the PE that creates a nexus between the group and the state of destination for agency contracts. If this strategy were followed, a group's products would not be directly sold in that territory by a group member, but by one or more independent sales agents. This implies that the group's products would continue to be sold in the same territory, such that the group would not have to renounce its customers, but without any physical presence.

As the suggested example demonstrates, the implementation of the CCCTB will not prevent groups of companies from making use of allusive strategies in order to reduce the weight of the sales factor in the state of destination, something that could be interesting when customers are resident in high-tax locations. Apart from considering this risk and adopting measures to counter it, it would be convenient if the CCCTB proposal were to echo the anti-abuse rules suggested by the OECD in the same context.[23]

Another weakness of the CCCTB proposal, as noted earlier in section 3., is its limited scope of application. Given that only fiscal groups with consolidated turnover above EUR 750 million will be obliged to apply it, transfer pricing methods will continue to be necessary and will continue to create obstacles to cross-border economic activity. The definition of fiscal group included in the proposal does not make things any easier. According to this definition, it would be perfectly possible for one or more entities directly or indirectly connected with the parent company of the group, taking part in the development of its economic activity under the same conditions as group members, to be not formally regarded as part of such a group in applying the CCCTB Directive. Consequently, transactions between the group and these kinds of related entities must be evaluated according to transfer pricing methods.[24]

18. *Supra* n. 6.
19. Based on the premise that the group's tax year coincides with the calendar year, the employees that should be taken into consideration would be those existing on 31 Dec.
20. The same rule is suggested in the CCCTB proposal for the valuation of the assets factor. As stated in art. 36.2, "Where, as a result of one or more intra-group transactions, an individually depreciable fixed tangible asset is included in the asset factor of a group member for less than a tax year, the value to be taken into account shall be calculated having regard to the number of months that the asset was included in the asset factor of that group member".
21. In line with economic theory, the demand for goods and services is something that exclusively depends on the market. In contrast to assets and labour, therefore, this factor is not under a company's control.
22. The same would happen, so that the example would be equally valid, if the group had an affiliated company in the state of destination.
23. *See* OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.
24. The same idea has been expressed by M.J. Weiner, *Formula Apportionment in the European Union: A Dream Come True or the EU's Worst Nightmare?*, CESifo Working Paper 667, pp. 6-7 (2002).

Apart from the possibilities of manipulation associated with the transfer pricing system, under this new regime, incentives would exist to force transactions between the group and related entities (that are not formally part of the fiscal group) for the sole purpose of changing the location of the factors included in the formula. The European institutions, therefore, would have to confront a dual problem: on the one hand, the possible manipulation of transfer prices in order to shift profits from one state to another and, on the other, the use of these kind of transactions to divert assets, labour and sales to those companies that, apart from being resident in low-tax locations, are excluded from the scope of application of the CCCTB proposal. Since the number of transactions between groups and related entities could be high, EU Member States and tax administrations could face serious problems in keeping these practices under control.

Due to this concern, the possible manipulation of the factors included in the apportionment formula could prevent the CCCTB proposal from achieving its goals and becoming an effective tool in the fight against aggressive tax planning strategies. Taking, as a starting point, the fact that the assets factor, and to a lesser extent the labour factor as well, is mobile in nature, and therefore open to manipulation, perhaps the European institutions should reconsider the adoption of an apportionment formula that does not make use of these factors. In this sense, a feasible alternative to counter aggressive tax planning strategies in the EU context would consist in a formula exclusively based on sales but measured by consumption.[25] Despite the weaknesses of this alternative, it should be taken into consideration that value added tax is a harmonized tax in Europe. Establishing a link between value added tax and corporate income tax would imply, at least, two important advantages: firstly, the opportunity to employ a wide range of location rules for sales and services that are already defined and consolidated and secondly, the chance to benefit from synergies and economies of scale in terms of administrative control. Additionally, the reduction in the number of factors would allow companies and tax administrations to save resources (both time and money) and would help to reduce the risk of tax evasion.

The major inconvenience of using a formula exclusively based on sales is that a company's profits would be assigned to the state where goods and services are consumed, rather than the territories where they have effectively been earned. In this way, the suggested alternative would require renouncing one key element of the CCCTB proposal. Taking into consideration the extensive advantages this alternative would bring about, however, it should not be dismissed off hand.

4. Conclusions

It is anticipated that implementation of the CCCTB proposal in the EU context will help to eliminate many of the tax obstacles that currently disrupt the correct functioning of the internal market. As some experts have warned, however, the application of a formula will not definitively put an end to aggressive tax planning strategies in the EU context.

Although the CCCTB proposal includes a series of anti-abuse rules in order to prevent companies from developing manipulation strategies, the experience of other countries using formula apportionment leads the author to question the effectiveness of the proposal in combatting the problem of aggressive tax planning in the European context. Furthermore, its limited scope of application would oblige a great number of cross-border groups to continue using transfer pricing methods. Therefore, problems associated with this valuation system will continue to exist and create obstacles to the correct functioning of the internal market.

As far as the author is concerned, there is no doubt that the transfer pricing regime should be replaced by a more effective system to fight manipulation and aggressive tax planning. However, designing an adequate method requires taking into consideration three essential aspects: (i) the experience of other countries with formula apportionment; (ii) the distinctive features of the European Union as a political unit; and (iii) the opportunities that being a part of such a union provide.

25. Concerning this proposal, *see* E. López Llopis, *Formulary apportionment in the European Union*, 45 Intertax 10, pp. 638-640 (2017), Kluwer Law Online Journals.

